1949



# *Monthly Letter on*

# Economic Conditions Government Finance

New York, October, 1949

## The Currency Devaluations

THE devaluation of the pound sterling, announced by the British Chancellor of the Exchequer in a radio speech Sunday, September 18, climaxed a summer of growing acuteness of the British exchange problem and mounting doubts that any practical alternative was left save devaluation. Once the step was accepted in principle, the British Government moved with vigor. Contrasted to prevalent rumors of a 20 per cent adjustment, the rate was put down 30½ per cent, from the old $4.03 to $2.80. Viewed from the other side of the water, the equivalent for a dollar was raised from a shade under 5 shillings to above 7 shillings – an upvaluation of the dollar of 44 per cent.

The British announcement came in the background of repeated denials that anything of this kind would be considered. Faced with an imperative need to reduce British costs and prices to foreign buyers, the choice settled down to deflation, with accompanying unemployment and business failures, or devaluation, with the risk of restimulating internal price inflation. There could be no question, Sir Stafford Cripps stated, of the British Government's accepting deflation as the way out. "Time is now so short and our reserves have got so low that a change in the dollar rate of exchange is the only way in which we can get our prices down quickly enough. We had hoped that growth of our productivity and other improvements would have made this unnecessary, but events have moved too fast."

Principal among the events that "moved too fast," and left no choice but drastic action of one kind or another, was the drain on currency reserves which, despite Marshall Plan aid on the one hand and oppressive measures of exchange and import restrictions on the other, could not be stopped. The picture that Sir Stafford drew was one of the United Kingdom as banker for the sterling area facing a run on its already shrunken reserves:

> Of course, when people saw that our reserves were falling rapidly, they began to wonder if their confidence in sterling was well placed. Talk had started last spring about our exchange rates in a way which led to doubt as to whether they were not too high. Once it was suspected that lowering might take place, people tried to turn pounds into gold and dollars by all sorts of devices. That is a very difficult thing to stop and there has been a good deal of it going on latterly. With low reserves we can't afford losses of that kind. We had to take steps to stop it.

### *Other Currency Changes*

As Britain broke the ice, most members of the sterling bloc and a number of other countries also moved to readjust the official value of their currencies. The Australian, Egyptian, New Zealand, and South African pounds were devalued in the identical ratio of 30½ per cent, as also were the Danish krone, the Indian rupee and the Norwegian krone. After a brief delay, while authorities appraised the situation, the Swedish krona and the Dutch guilder were devalued in similar degree. Thus, 30 per cent adjustments

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extended to almost the whole of the "sterling area", plus the closely allied Scandinavian group, the Netherlands, and Egypt. Pakistan, a member of the sterling area, decided against revaluation.

**Principal Currency Readjustments**
**September, 1949**

| Country and Currency | | Date of Change | Foreign Currency Values Expressed in U.S. cents: Official Valuation on Sept. 17, 1949 | Official Valuation on Sept. 29, 1949 | Percentage Reduction in Official Valuation |
|---|---|---|---|---|---|
| *Untd. Kingdom | pound | Sept. 18 | 403. | 280. | |
| *Un. of S. Africa | " | " | 403. | 280. | |
| *Ireland | " | " | 403. | 280. | |
| *Australia | " | " | 322.4 | 224. | |
| *India & Ceylon | rupee | " | 30.225 | 21. | |
| *Malayan Straits | dollar | " | 47.0167 | 32.6667 | |
| *Hong Kong | " | " | 25.1875 | 17.5 | |
| *New Zealand | pound | Sept. 19 | 403. | 280. | —30 |
| *Iraq | dinar | Sept. 20 | 403. | 280. | |
| Norway | krone | Sept. 18 | 20.15 | 14. | |
| Denmark | " | " | 20.8376 | 14.4778 | |
| Egypt | pound | Sept. 19 | 413.8 | 287.156 | |
| Sweden | krona | " | 27.778 | 19.3057 | |
| Finland | markka | " | 0.625 | 0.435 | |
| Netherlands | guilder | Sept. 20 | 37.6953 | 26.3158 | |
| Canada | dollar | Sept. 19 | 100. | 90.909 | — 9 |
| France | franc | " | 0.368† | 0.286† | —22 |
| Portugal | escudo | " | 4. | 3.48 | —13 |
| Italy | lira | " | 0.174† | 0.153† | — 9 |
| Belgium | franc | Sept. 21 | 2.2817 | 2. | —12 |
| Thailand | tical | Sept. 27 | 10. | 8. | —20 |
| West. Germany | mark | Sept. 29‡ | 30. | 23.8095 | —21 |

*Member of sterling area. †Effective export rate. ‡Retroactive to Sept. 19.

The relatively stronger currencies were undisturbed or subjected to smaller adjustments. The Swiss franc came under pressure as holders shifted funds to U. S. dollars or to sterling and the Swiss authorities raised very slightly their selling price for the dollar. The French franc was allowed to depreciate in regulated open market trading as was the Italian lira to a smaller extent. The Canadian dollar was devalued 9 per cent, the Belgian franc 12 per cent, and the Portuguese escudo 13 per cent. At the close of the month further changes were under consideration, including possible part-way adjustments by a number of South American countries. In the Argentine, which has close trade ties with Britain, foreign exchange transactions have been suspended for the time being.

All the currencies which joined with the pound in the 30 per cent adjustment were "soft" not only in comparison with the U. S. and Canadian dollars and many of the Latin American currencies, but also in comparison with the Swiss, Belgian, and French francs, and the Italian lira. All of them previously had been depreciated in "black" and "gray" markets where currencies sell for what they will bring rather than what governments say they are worth. The currency revaluations dealt a sharp blow to this traffic, in effect by raising official bids for dollars to what private traders had been willing to pay or even more. The governments concerned should now get most of the dollars which previously went into these markets. This should be considerable help in itself to the British position. The devaluation also stimulated purchases of sterling which had been deferred in anticipation, and the British authorities thus realized immediate gains to their dollar reserves.

There were two special reasons why so many changes came at once. A number of continental European countries had felt the need for devaluation ever since the downward turn came in commodity markets last winter but thought it unwise to act except as part of a general structural rearrangement. Here it was a matter of waiting for sterling, a key to the whole equation.

In the second place, when Britain made such a wide adjustment, some countries were impelled to make changes in currency valuations which under other conditions might have been deferred.

***Views of International Monetary Fund***

Sir Stafford Cripps revealed in his radio announcement that devaluation had been decided upon by the British Government prior to his embarkation for the Anglo-American-Canadian talks held at Washington, September 7-12, and the annual meetings of the governors of the International Monetary Fund and World Bank, again at Washington, September 13-16. He also indicated that Britain complied with the requirements of "consulting" with the Fund, and obtained the Fund's agreement, beforehand. Nevertheless, contrary to popular expectations, overall plans for exchange rate changes did not come up for discussion at the Fund's annual meeting. The new pattern of rates that emerged toward the close of September sprang in considerable measure out of efforts, after Britain had acted, to adjust to a *fait accompli*.

On the other hand, there can be little doubt but that the new alignment of exchange rates is closer to "realities", and gives a better base for a reordering of world trade than the structure that it displaced. The International Monetary Fund had recognized from the start the tentative and insecure basis of exchange rates existing or set up at the close of the war. In its first Annual report, three years ago, the Fund stated:

> We recognize that in some cases the initial par values that are established may later be found incompatible with the maintenance of a balanced international payments position at a high level of domestic economic activity. Because the entire world is in need of goods, some countries may maintain foreign exchange values for their currencies which are not for the time being a great handicap to the sale of their exports, but which prove to be too high when production is revived all over the world and the immediate shortage of import goods is in large part met. Such countries may later find

difficulty in selling sufficient exports to pay for needed imports.

This year, with the disappearance of sellers' markets, the problem to foreign countries of getting prices and costs down to a competitive level has become acute. The Fund's report for 1949, released to the press September 13, after showing a 20 per cent differential between Western European and American prices of manufactured goods, analyzed the problem in the following language:

> These high export prices impose a serious handicap on deficit countries as they endeavor to expand their exports to the Western Hemisphere. There may be some scope for price reduction by a lowering of profit margins, although these possibilities are necessarily limited. The ultimate limit to price reduction is set by production costs. A reduction in costs through greater efficiency is at best a slow process, although the investment already undertaken and in prospect may offer hope in this direction. Many cost elements are notoriously rigid, and any general deflationary program for lowering costs and prices would encounter formidable resistance. Where a price reduction of the magnitude indicated above is necessary to expand exports, it would in many cases seem possible only through an adjustment in the exchange rate.

Mr. Eugene R. Black, President of the World Bank, speaking at the annual meeting of its Board of Governors, put as a first need of European countries "the establishment of a system of exchange rates which will assist the dollar-deficit countries to compete effectively in world markets, will furnish an incentive to exporters to increase their sales in the dollar area and will encourage importers to buy, to the extent possible, in countries whose currencies they can best afford." Another prescription which Mr. Black gave for a solution of the dollar problem was to "start clearing away the wilderness of bilateral arrangements, special currency controls, quotas and similar restrictions, both internal and external, which have grown up over the past 20 years." It has been pretty well demonstrated, he commented, that "productive efficiency cannot be brought about merely through governmental edict or exhortation."

### *The Pound Now Too Cheap?*

Some complaints were heard that the British action went too far, and that the pound, from being too dear at the official valuation, may now have been made too cheap. Finance Minister Maurice Petsche of France described the new pound rate as "a trade war rate for competition in international markets". Competition for exports certainly will be sharpened throughout the world.

From the British viewpoint, a rate that is too low puts more pressure on internal prices and accentuates inflationary forces, but it does improve their competitive position. Sir Stafford, who properly described the change as "drastic", noted in his speech that, "we can always let the rate go up if events prove that we have gone down a bit too low." His objective was to put the pound down to a rate that could be held.

Before any solid conclusions can be drawn that sterling *has* been made too cheap, it will first have to be demonstrated that $2.80 is a rate at which sterling convertibility ultimately can be restored, while at the same time serious inflation of sterling prices and costs is avoided. That will be the final test.

## General Business Conditions

In domestic business, the currency devaluations, together with the suspension of coal mining and threat of a steel strike in this country, have made September an eventful and confusing month. People understand that the markdown of the world's principal currencies against the dollar exerts a downward pull on our prices and trade, but how far this influence will reach is still to be seen. Moreover, it is only one of many influences in the business outlook. Coal and steel strikes, if prolonged, will paralyze industry. Stocks of bituminous coal above ground are large, but as we go to press hope of averting a steel strike has been virtually abandoned.

Meanwhile current reports from the industries and trade have continued to give satisfaction. During the past three months the decline in business buying and industrial production has not only been arrested, but in many lines strongly reversed. Order books which were emptying through the first half of the year have been replenished, workers recalled, and factory operations stepped up. The position in cotton and rayon goods, in electrical appliances, and in many types of general merchandise has turned from weak to strong. Retail buyers are operating farther ahead. Basic commodities, including nonferrous metals, steel scrap, petroleum, paperboard, and various other products, have firmed under better demand.

Business has had strong support from record-breaking output of automobiles, and from an immense volume of construction work. Seasonal influences usually are expected to slow down construction contracts by this time, but the August figures were 6 per cent above a year ago, according to the F. W. Dodge Corporation, and the daily average for the first half of September was the highest of any month this year and 36 per cent above the same period in 1948. The steel industry is contributing more to overall activity

than the pessimists expected. The pickup in buying — influenced in part, to be sure, by fear of a strike — has reached such size that Iron Age September 22 said mills had enough orders on hand or in sight to support operations at or close to the current rate of 85 per cent through the fourth quarter.

### *The Force Behind Recovery*

The force behind the recovery has been the immense buying power of the country, fortified by huge liquid savings and government supports. While pipelines were being emptied and commitments reduced through the Spring, demand for goods of everyday use was relatively sustained. The turn came naturally when stocks had to be replenished and commitments replaced.

This improvement has done much to lessen business pessimism, which in some quarters was becoming acute last Spring. At the same time, current comment suggests that sentiment is not likely to go to the opposite extreme, and lead to recklessness. In the longer view the weakness of the recovery is that it has been largely in consumer goods, and is based on refilling pipelines. To that extent the pickup will lose momentum when replenishment has gone as far as buyers think advisable. Recent softening in lead prices is a case in point.

Fundamentally, reasons for caution exist. In ordinary circumstances a turn of this kind might be followed by an increase in business spending on plant and equipment. But after the enormous investment for these purposes in the past three years the trend now is downward. Many expect a drop in farm income to result from lower prices for some products together with crop curtailment next year. The automobile industry seems to be catching up with needs, as other industries did earlier, and hardly expects to keep going at its recent phenomenal rate.

### *Effects of Currency Devaluation*

The effects of the chain of currency devaluations upon United States prices and trade evidently will be governed more by conditions in various markets than by abstract or theoretical considerations. The effect upon international capital movements will depend largely on future developments, and on sentiment.

Cheapening of currencies in terms of U. S. dollars means that foreign producers can sell their goods for less dollars while receiving the same or higher prices in their own currency. Conversely, they must pay higher prices in their own currency for this country's products, other things being the same, and presumably must buy less. Thus devaluation tends to depress dollar prices and exports. It is equally true, however, that the effects may largely take the form of a rise in prices in the devaluing country, in part because its imports cost more and in part because demand from the United States may sustain dollar prices and give foreign exporters correspondingly higher prices in their own currency.

In this country many may think the major effect of the devaluations is to "export deflation" from Great Britain, for example, to the United States. But it is also true that the British may "import inflation." To the extent that British prices rise, depressing effects upon prices in this country are averted.

### *Reaction of Commodity Prices*

The first effects of the British devaluation have been to raise sterling prices more than they have lowered dollar prices. Although the sterling devaluation was 30.5 per cent, at the time of writing only wool and sisal, among the important basic commodities produced in the sterling area, have declined in the American markets by as much as 10 per cent, and the average decline in imported staples has been only 3 or 4 per cent. By contrast a sensitive index of staple commodities in London has gone up 17 per cent. The British authorities have raised prices of copper, lead, zinc, and cotton to levels approximately in line with American markets, calculated at the new sterling rate. Canadian producers of newsprint and of non-ferrous metals have also raised Canadian prices of their products by the equivalent of their 9 per cent devaluation, thereby keeping dollar prices unchanged.

The price of natural rubber in the United States by the end of September had dropped 7 per cent, while in Singapore in local currency it had risen 20 per cent. At the current quotation of 17 cents natural rubber enjoys a price advantage over the synthetic rubber with which it competes here. Moreover, U. S. regulations requiring the use of specified amounts of synthetic rubber are being modified to open the way for larger imports of the natural product; and the world statistical position is not weak. The price of sterling area tin has been reduced from $1.03 to 95c (8 per cent) in American money, and raised from £569 to £750 (32 per cent) in London. Cocoa here has declined about 9 per cent, and the influence of the British selling agency is naturally exerted to obtain higher local prices rather than sharply lower dollar prices.

In manufactured goods the British policy is the practical one of cutting dollar prices where cuts are needed to sell more, and of holding

prices, wholly or largely, where cuts are not needed. The reduction in dollar prices has ranged from nothing at all in the case of whiskey and some other articles, to around 20 per cent in the case of British automobiles, which had become difficult to sell here. In important instances, for example china, where British manufacturers are sold far ahead, sterling prices have been marked up by a larger percentage than dollar prices have been marked down.

What the situation may be when Great Britain has more trouble selling her products abroad remains to be seen. But in lines where she does not now lack for markets the natural tendency is to get the highest price possible. All this accords with the realities of the markets. As long as Americans can and will pay present prices for all the Canadian newsprint and Scotch whiskey they can get, the effect of devaluation is to "import inflation" into the devaluing countries rather than to "export deflation" to the United States.

If an average of the percentage of devaluation in countries from which the United States buys is calculated, weighted by the distribution of our imports according to their source, the result works out at approximately 20 per cent. Half of our imports come from countries which devalued. Thus, if dollar prices of these products should be reduced by the full extent of the devaluation the average cost or price of our imports would be reduced about 10 per cent. In view of the many indications that devaluation will tend to raise foreign currency prices more than it reduces dollar prices, it is probable that the weighted average drop in the price of all our imports will be substantially less than 5 per cent, while conditions remain as they are. This, to be sure, may have competitive effects in the American price structure and lead to price declines in other categories.

### *Our Export Commodities*

American commodities moving to Great Britain cost the British about 44 per cent more in sterling, as long as American prices are unchanged. This increase tends to reduce British consumption and depress American prices until a balance is reached. However, there are other considerations. The British economy must import raw materials and food, and has limited its purchases rigorously for a long time past.

Naturally the British will divert their buying even more, if possible, to countries whose currencies have also been devalued, rather than buy in the United States. But they have already gone far in that direction. The impact of any drop in demand on American commodities will be cushioned by two other influences. One is the fact that European countries are receiving grants and aids from this country in the form of dollars or commodities for which they do not have to pay. Second, lessened foreign purchases of American farm products will be cushioned by our agricultural price support programs. If Britain takes less American wheat, cotton and tobacco, so much more will flow into the stocks that the U. S. Government withholds from the market to support prices.

### *Effects on Trade*

On trade, the tendency of the devaluations will be to increase the volume and perhaps even the value of United States imports, and to reduce our exports. However, it is hardly to be expected that if our imports are well maintained our exports will decline much. The inconsistency of such belief is apparent. The world wants American goods and services and tends to spend all the dollars it can get for them. Demand for American products has been held back not by prices, but by scarcity of dollars, import quotas and similar restrictions. If business holds up well in this country our imports will continue large, and the dollar earnings of our foreign suppliers will hold up.

The accompanying table is a condensed version of the U.S. balance of international payments for 1947 and 1948 with estimates for 1949. It shows how much foreign countries bought from us and how the dollars were obtained to balance the accounts. It would be premature to make estimates for 1950, since the import totals will be so largely affected by the level of business here. However, shipments under the foreign aid program will continue huge, although somewhat

**Financing U. S. Exports**

(In Billions of Dollars)

| Factors Using Dollars (Receipts from Foreigners) | 1947 | 1948 | 1949 Estimate |
|---|---|---|---|
| Merchandise exports | 16.1 | 13.4 | 12.7 |
| Services rendered | 2.6 | 2.1 | 2.0 |
| Investment income earned | 1.1 | 1.3 | 1.2 |
| Total dollars used | 19.8 | 16.8 | 15.9 |
| **Factors Supplying Dollars (Payments to Foreigners)** | | | |
| Merchandise imports | $ 6.1 | $ 7.7 | $ 6.7 |
| Tourist travel | .5 | .6 | .8 |
| Other services | 1.6 | 1.9 | 2.0 |
| Investment income paid out | .2 | .3 | .2 |
| Remittances (net) | .6 | .6 | .5 |
| U. S. Gov. grants and gifts | 1.8 | 3.8 | 5.2 |
| U. S. Gov. loans and credits | 3.9 | .9 | .6 |
| Private U. S. loans and invest. (net) | .7 | 1.0 | .3 |
| International credits and invests.(a) | .8 | .4 | .3 |
| Liquidation of gold and dollar assets | 4.5 | .9 | .4 |
| Total dollars supplied | 20.7 | 18.1 | 17.0 |

(a) By the International Monetary Fund and International Bank.

Source: U. S. Dept. of Commerce, except for 1949.

lower than in 1949. By all indications American tourist expenditures abroad will be larger than in 1949. Loans by international institutions are expected to be larger. New gold production will be stimulated by devaluation.

Overall, it must be considered probable that the supply of dollars available to foreign countries for purchases here will be little, if any, lower than it is this year. To be sure, if our foreign customers choose to replenish reserves of gold or dollars for stabilization purposes, rather than spend them for goods and services, our exports might be substantially reduced. Possibly there will be a tendency in that direction. However, the needs and desires of the rest of the world for American goods are still great and urgent.

These considerations suggest that pessimism as to the effects of devaluation on U.S. exports may be overdone. In specific lines where the devaluing countries can supply buyers with what they want, and now at lower prices, American shippers will suffer. Domestic producers of goods which may now come from abroad in greater volume will face stiffer competition at home. But the successful foreign sellers will be earning dollars which will be available for other things.

### *Effects on Capital Movements*

When Great Britain abandoned the gold standard in September 1931 and permitted the pound sterling to find it own level in the markets, the most dramatic and influential effect upon the United States was the cashing in, for conversion into gold or withdrawal home, of foreign balances held in this country. In the succeeding ten months this country lost $1,100 million of gold. Foreign funds held in American banks declined by $1,350 million. The drain on our reserves and our money supply was a substantial cause of continuing deflation of American markets and business through those months.

Now foreigners again have large balances here, including some $5.7 billion of funds payable on demand or short notice. Remembering 1931, and possibly also with an eye on the low rate now set for the pound, some wonder whether a substantial capital outflow, deflationary on our markets, may not again set in.

As compared with 1931, however, the present situation seems to offer more differences than parallels. The main difference is that in the devaluing countries capital movements are strictly controlled. People who elect to put their money in those countries will have no assurance that they can get it out again when they want to, — rather the contrary. A second consideration is that some part of the foreign money here, which has evaded efforts to compel or induce its repatriation, could not now be returned abroad without possibility of incurring heavy penalties. The third and perhaps the most significant difference is that no real apprehension about the American dollar relative to other currencies is evident. It is true that some people in this country as well as abroad have talked of raising the price of gold here. However, there is no sound argument for such an action. Secretary of the Treasury Snyder has recently taken the position that it is unworthy of serious consideration.

In view of these differences, few informed people believe that any substantial outflow of capital, sufficient to exert a pronounced deflationary effect upon this country, is to be anticipated. Finally, the banking position of the United States is so strong and its reserves so large that any likely outflow of foreign funds could be sustained without embarrassment. Deflationary effects could be offset, to any degree necessary, by Federal Reserve action.

### *Can Trade Restrictions Be Lightened?*

Americans who are concerned lest devaluations abroad exert a strong deflationary influence on this country should find reassurance in careful examination of all the factors involved. Far from feeling concern about our own situation, our strongest hope should be that these momentous steps may mark the beginning of a period in which trade can expand, — in which the world can move gradually toward a relaxation of import restrictions and exchange controls, and toward restoration of multilateral settlements and free convertibility of the world's currencies.

Trade is hampered and restricted because countries cannot convert the currencies of the countries to which they can sell into the currencies of the countries from which they wish to buy. If confidence now increases in the devalued currencies, and if the devaluing countries can begin to add to some extent to their currency reserves on the new basis where they could not on the old, they may be able to initiate relaxations of their restrictions and controls. Of course devaluation in itself will not solve the problems in the way of the restoration of multilateral trade and currency convertibility. It can only be hoped that the occasion may be improved by making whatever preliminary and tentative moves in that direction are possible, and supporting them with the more fundamental policies required. If this is the outcome, the devaluations will justify themselves.

If a beginning can be made, the United States will benefit with other countries. American business must face the fact that the export surplus we now enjoy exists only by grace of our own grants and aids. When the aid is discontinued, and to the extent that it is not replaced by other foreign investments, the export surplus must disappear. The competition offered to American products both abroad and at home must inevitably become more severe.

Rightly seen, this ought not to be regretted or opposed. No country can be enriched by giving away goods which otherwise could be devoted to improving the standard of living of its own people. Nor should we fear competition, for two reasons. One is that competition stimulates effort and efficiency, which is the basis of progress. The second is that the United States, with its immense resources and technical accomplishment, in the long run can hold its ground anywhere, provided always that through its own official policies and the understanding and cooperation of its people, it maintains a sound, progressive and flexible productive organization.

## Anglo-American-Canadian Talks

The devaluation of sterling came a week after the conclusion of tripartite Anglo-Canadian-American discussions held in Washington, September 7-12, to consider what each of the three nations might have to contribute toward a solution of the "sterling-dollar" problem. The September talks carried forward preliminary consultations in London early in July at the time that the British Government recognized that the deterioration of its exchange position would require some drastic kind of correction.

The talks themselves went over the familiar facts of the British balance of payments problem. The British representatives conceded that the sterling area must increase its dollar earnings if Britain is to pay its way by 1952, the terminal date of the Marshall plan, and that this will require in the sterling area "the creation of appropriate incentives to exporters to the dollar area" and "a vigorous attack upon costs of production." At that time the devaluation of sterling as a means of doing this was not mentioned.

The American and Canadian conferees conceded that the United States and Canada should reduce obstacles to the entry of goods and services from debtor countries, and to this end should review troublesome customs procedures. The conferees noted the significant and substantial reductions in United States tariffs during the last fifteen years. Extension of the Trade Agreements Act, which will permit negotiation of further reductions, was given approval by the Congress September 15.

### *Possibilities for Investments Abroad*

The American and Canadian representatives agreed that a flow of productive investments, both private and public, from North America to underdeveloped countries could make an important contribution toward reducing the "sterling-dollar disequilibrium." The President's Committee for Financing Foreign Trade has been asked to explore the possibilities, addressing itself especially "to the problem of incentives and of providing a suitable environment for a high level of private investment."

The United States conferees were unreceptive to British feelers for inter-governmental efforts to stabilize prices for basic commodities of which sterling area countries are large producers. Such price-stabilizing activities, directed towards price-*raising*, could benefit the British balance of payments but only to the injury of the consumer. It was indicated, however, that the United States Government would review its stockpiling program with particular reference to rubber and tin. Subsequently the proportion of synthetic rubber which American rubber manufacturers are required to use has been reduced.

Agreement was reached that the United Kingdom might be released from some of the present restrictions on the use of Marshall plan funds, within the limits set by the Economic Cooperation Act. The primary intent here was to permit the United Kingdom to buy wheat in Canada rather than in the United States even though wheat now is in surplus supply in our markets. This concession will help Canada and Canada's ability to buy in this market.

### *Wartime Sterling Debt*

The conferees also explored some topics which they concluded would require further study before any kind of decision could be reached. The largest of these – and the thorniest – is the problem of the exceptionally large accumulations of sterling by foreign central banks and governments, which represent to London a massive floating debt. These balances, built up mainly during the war, as a result of payments by the United Kingdom for goods and services, ran to \$13½ billion at the close of 1948, approximately the same as at June, 1945.

At the time of the Anglo-American loan agreement in 1945, the British Government stated its intention to make agreements with the creditor countries – principally sterling area countries –

for an "early settlement" of these balances. What was envisaged then was that:

> The settlements with the sterling area countries will be on the basis of dividing these accumulated balances into three categories (a) balances to be released at once and convertible into any currency for current transactions, (b) balances to be similarly released by installments over a period of years beginning in 1951, and (c) balances to be adjusted as a contribution to the settlement of war and postwar indebtedness and in recognition of the benefits which the countries concerned might be expected to gain from such a settlement. The Government of the United Kingdom will make every endeavor to secure the early completion of these arrangements.

The carrying out of this plan has proved a "hot potato" difficult to grasp. The creditor countries, on their parts, principally India and Egypt, quite naturally were reluctant to see frozen up, or written off, sterling balances which either formed a part of their currency reserves or could be applied to plans for economic development which they have been eager to prosecute. The hard fact on the other hand is that, so long as these vast obligations remain in the present form of floating debt, the creditors have the potential power to claim any and all dollars that Britain has or is likely to get or earn by her own efforts. What has been needed – for the solvency of Britain as a banker for the sterling area – has been a refunding of the bulk of this indebtedness.

The devaluation has pared down the sterling balances, in terms of gold and dollars, by 30 per cent. Thus the potential claim of the creditor countries, upon Britain, for conversion of sterling they hold into dollars has been whittled down by $4 billion, or from $13½ billion to $9½ billion. This "writedown", involved in the devaluation, should provide some relief to the drain on British gold and dollar reserves from the demands for conversion of sterling assets by the creditor countries.

The devaluation does not, of course, change the amounts of the balances expressed in terms of sterling, but there will be a shrinkage in command over British exports to the extent of the resultant rise in British export prices. Thus the weight of the sterling indebtedness has been eased, though its floating character has not been changed, and it remains one of the greatest burdens on sterling.

## Devaluation — Palliative or Cure?

Turning from the effect on the United States, the other question is whether devaluing the pound sterling will prove an effective means of restoring trade equilibrium between the sterling and dollar areas, and halting the drain on Britain's gold and dollar reserves, or whether its benefits will prove to be temporary and illusory, to be followed by reappearance of the same old difficulties, in perhaps aggravated form, when the first effects wear off.

To state the crucial issues –

1. Can costs of production in Britain be prevented from rising to the point of cancelling out the effects of devaluation in cheapening the prices of British goods in dollar markets?

2. Can the sale of British goods and services to the dollar area be sufficiently expanded by devaluation so that the greater quantity of goods and services exported will not only make up for the decrease in their prices but garner enough additional dollar exchange to reduce the sterling-dollar problem to manageable proportions?

### *Problem of Costs and Prices*

As to the first point, Sir Stafford warned that "we must avoid anything that increases the cost production." As he told the British people –

> If any of us were to take steps that tended to increase the cost of production, and so prices of our manufactures, we should be acting contrary to the very purpose for which we are making this change. Our sacrifices would be thrown away.

The Chancellor acknowledged that "we shall have to pay more sterling for the same quantity of dollar goods." At the same time he endeavored to reassure his hearers as to the impact of such increases on the cost of living. Apart from an increase of a penny in the price of bread, due to higher cost of wheat and flour from North America, and represented by a rise in the cost of living index of nearly one point, "there should not be," he stated, "any noticeable increase in other retail prices, at least for the time being."

Despite these assurances by the Chancellor, comments in both labor and business circles indicate a widespread feeling that this is too optimistic an appraisal of the situation. While it will take some time to disclose the full effects of devaluation, already sterling prices of numerous basic commodities have advanced. This includes not only commodities imported from the dollar area, but also such sterling area products as rubber, wool, and non-ferrous metals. To the extent that higher raw material costs enter into the prices of British manufactures they tend both to impede the effort to expand sales abroad and to raise home retail prices, already under fire from the trade unions.

It is on this latter point that the principal anxiety is felt. While trade union leaders, by and large, have supported the Government in its effort to restrain wage increases, they have done

so with the understanding that the cost of living would be held stable. Even before the recent developments, however, the rank and file of the labor organizations was becoming increasingly restive, and pressure for higher wages was becoming more insistent. The announcement, therefore, that devaluation means an increase in the price of bread, with expectations of further increases in the cost of living to come, puts the policy of wage-freezing to a severe test. Unless labor exercises great self control, a process could be set in motion which, as the London Times says, "could wipe out the competitive advantage of the new exchange rate and only lead to necessity for yet another downward change in the value of sterling."

### *More Sales Required to Yield Same Number of Dollars*

The second crucial question arising out of devaluation is whether sales to the dollar area can be expanded sufficiently to bring in not only the same number of dollars, but enough more to make a real gain in Britain's foreign exchange position.

This problem can be approached from two angles — one from that of demand. No doubt the 30 per cent discount on sterling will provide a strong inducement for importers in the dollar area to expand purchases of many sterling area products. There are, however, a number of qualifying factors. In the first place, a substantial portion of the retail price to the American consumer is made up of ocean and domestic freight and handling charges, insurance, and import duties, as well as the retailer's overhead and profits, and hence is little if at all affected by devaluation.

Secondly, there is the question mentioned earlier as to just how elastic the American demand for British products will prove to be. For certain types of textiles and miscellaneous consumer goods, devaluation may well bring a sharp upturn; but it is doubtful how much sales of British motor cars — to go back to that example — can be stimulated, now that American cars are in plentiful supply. For numerous raw materials which constitute a large segment of our imports from the sterling area, demand is less dependent upon prices than upon the state of general business and the actual consumption in the industries.

Finally, as soon as devaluation was announced the sterling prices of many exportable goods were promptly marked up, which tends to limit the reduction in American prices as well as the extra shipments of goods needed to produce the same dollar return. As to this latter point, the British Government has, in fact, encouraged exporters to increase their sterling prices, where they have an assured dollar market, in order to bring in the maximum amount of dollar exchange. Such pricing policy modifies and makes more selective the effects of devaluation, and indicates the unrealism of calculations that a 30.5 per cent devaluation would require a 44 per cent expansion in British exports to maintain the same dollar yield.

Turning to the angle of supply, an equally important part of Britain's problem of expanding her dollar markets is having the goods to sell. Most British factories are already producing to the capacity allowed by raw material supplies and the availability of labor. Unless productivity can be substantially increased, the question comes down to how much of a flow of British goods might be diverted to dollar markets from other areas.

Actually, during the past two years, a large portion of Britain's exports have reflected releases from Britain's huge sterling liabilities built up during and after the war and owing mostly to soft currency countries. Though this process had the effect of pre-empting British goods and productive resources for exports for which the country received no goods in return, the individual British exporter had no reason to be dissatisfied with this business which was yielding him good profits with a minimum of sales competition. The devaluation of sterling will increase the incentive for British merchants to seek sales in the dollar area.

### *Devaluation No Panacea*

All these complexities and uncertainties only demonstrate the more forcibly that devaluation provides no panacea for the difficulties such as those from which Britain has been suffering. Devaluation, alone and unassisted, cannot restore sterling convertibility or end Britain's "dollar shortage". It goes far to rectify, for the time being at least, and by one stroke of the pen as it were, the disparity between costs and prices which has impeded the sale of British products in dollar markets and encouraged British purchases in America. It has halted the pressure upon sterling resulting from selling by holders who feared its depreciation and from leakages of dollar earnings into outside markets. With devaluation now a *fait accompli*, there is again a vigorous demand for sterling for current purchases, for making up deferred commitments, and for replenishing depleted balances.

Whether devaluation proves to be merely a palliative or a road to a genuine cure, comes back to the fundamental question as to whether the short-run gains that have been achieved can be consolidated by real progress in reducing costs and increasing the productivity of the British economy. For without such progress no mere marking down of currency values can over the long run enable Britain to sell in the world markets enough goods and services to pay for those which she herself requires.

This problem of reducing costs and increasing production is compounded of many elements. It includes not only wage rates, but also such matters as further modernization of industrial equipment, lessening of restrictive practices on the part of labor or industry, control over money and credit, relief from confiscatory taxation, and in general the development of an economic climate that stimulates enterprise and induces capital investment. Private capital, which exchange controls have especially sought to keep in and notably succeeded in driving out, is perhaps the greatest potential force which could make for a basic turn in the British economic position.

## Cost of Government in Great Britain and the United States

In all informed discussion of British problems the need to reduce the cost of government looms large as an essential step for strengthening and stabilizing the pound sterling. Paring down of the national government's expenditures, which represent the bulk of public spending in Great Britain, would help in a number of ways. It would offset to some extent the inflationary effect of the devaluation. Even more important, tax reduction would provide incentive and promote the formation of capital. By discouraging saving and penalizing initiative, excessive taxation has seriously impeded Britain's efforts along the road to recovery. Writing in the New York Times Magazine, Mr. Richard H. Fry, the financial and industrial editor of the Manchester Guardian, observed only a week ago:

> From top to bottom, from millionaire to miner, people are sick and tired of the present weight of taxes. The worker refuses to do a few hours overtime because the extra pay attracts the full rate of income tax. The business man drops a project that involves some risk because his company keeps only 40 per cent of the profit, and he himself, if subject to super-tax, may get only a small fraction of the final dividends.

How do British tax rates compare with ours? What is the cost of financing the Welfare State? Can the oppressive burden of Britain's taxes be reduced? In the table on the next page, a comparison is made of the British and American taxes, national (federal) and local, and of their relationship to the national income of the two countries; also a comparison of costs of the various functions of the modern state. The reader should be cautioned that complete accuracy in comparisons and computations of this type is well nigh impossible because of the nature of the data, which in this country must include the tax collections and expenditures of at least six different types of public authorities.

The table shows that on a per capita basis, the federal and other public authorities in the United States collect and spend more than the national and local authorities in Great Britain. Including payments for unemployment and social security schemes, the per capita tax burden in the United States averaged about $383 in 1947 and 1948. The corresponding figure for Great Britain was £81.6 or $329 at the then-existing exchange rate, and $228 at $2.80 for the pound.

The oppressive weight of British taxation is, however, revealed in comparisons with national income or product. In Great Britain, the national and local governments taxed away over 39 per cent of the national income in the two years covered; the comparative figure for the United States was about 24 per cent. The British have been taxing themselves more than any other free nation of the Western World, and (in the opinion of British and outside observers alike) more than any economy can stand over a long term without sapping its energy and ultimately strangling it. If the thesis of the Australian economist, Mr. Colin Clark, is correct, when taxes exceed 25 per cent of the national income, it becomes impossible to resist inflationary pressures. Among the reasons which Mr. Clark advances is that "the incentive to real effort is greatly weakened on the part of all classes".

### Financing of Welfare State

Turning to expenditures, it will be seen that somewhat more than one half of the collected revenue, or about 21.4 per cent of the national income in 1947 and 1948, was used by Great Britain to pay for what may be called the fundamental functions of the Government: general administration, debt service and national defense, plus some foreign aid. Per capita, the cost of these functions to the British tax payer in 1948 was about £44.5.

The remaining expenditures, representing in 1948 over 16 per cent of the national income or £35 per capita, went to pay for a wide range of social benefits which at the present time comprise: free education, medical attention including

**Tax Collections and Government Expenditures in the U. S. and U. K.**

| | Great Britain | | | | United States | | | |
|---|---|---|---|---|---|---|---|---|
| | Total (in 000,000) | | Per Capita | | Total (in 000,000,000) | | Per Capita | |
| | 1947 | 1948 | 1947 | 1948 | 1947 | 1948 | 1947 | 1948 |
| Population (in millions) | 49.5 | 50.0 | | | 144.0 | 146.6 | | |
| National product | £10,110 | £10,620 | £204.2 | £212.4 | $222.0 | $247.0 | $1,542 | $1,685 |
| **Tax collections:** | | | | | | | | |
| Tax collections, national | 3,280 | 3,680 | 66.8 | 73.6 | 37.9 | 40.9 | 263 | 279 |
| Tax collections, local | 310 | 290 | 6.3 | 5.8 | 13.2 | 16.4 | 92 | 112 |
| Social security taxes | 230 | 330 | 4.6 | 6.6 | 1.5 | 1.6 | 10 | 11 |
| Total taxes and charges | 3,820 | 4,300 | 77.2 | 86.0 | 52.6 | 58.9 | 365 | 402 |
| Taxes as per cent of national product | 37.8 | 40.5 | | | 23.7 | 23.8 | | |
| **Expenditure other than Welfare** | | | | | | | | |
| National defense | 850 | 750 | 17.2 | 15.0 | 14.3 | 10.9 | 99 | 74 |
| Public debt charges (incl. local) | 600 | 580 | 12.1 | 11.6 | 5.5 | 5.8 | 38 | 40 |
| Foreign aid (incl. colonial) | 120 | 60 | 2.4 | 1.2 | 6.4 | 7.7 | 44 | 52 |
| Public service and administration | 750 | 720 | 15.2 | 14.4 | 6.7 | 8.6 | 47 | 59 |
| Total above expenditure | 2,320 | 2,110 | 46.9 | 42.2 | 32.9 | 33.0 | 228 | 225 |
| Above expend. as percent of tax collections | 60.7 | 49.1 | | | 62.5 | 56.0 | | |
| Above expend. as percent of national product | 22.9 | 19.9 | | | 14.8 | 13.4 | | |
| **Welfare expenditure:** | | | | | | | | |
| Veteran compensation, etc. | 110 | 100 | 2.2 | 2.0 | 7.6 | 7.2 | 53 | 49 |
| Food subsidies | 380 | 470 | 7.7 | 9.4 | 1.1 | .4 | 8 | 3 |
| Housing and other subsidies | 100 | 90 | 2.0 | 1.8 | | | | |
| Social security payments | 370 | 470 | 7.5 | 9.4 | 2.9 | | 20 | |
| Education | 210 | 240 | 4.2 | 4.8 | 4.1 | 4.6 | 28 | 31 |
| Health, family allowances | 250 | 380 | 5.1 | 7.6 | 2.6 | | 18 | |
| Total above expenditure | 1,420 | 1,750 | 28.7 | 35.0 | 18.3 | | 127 | |
| Above expend. as percent of tax collections | 37.2 | 40.7 | | | 34.8 | | | |
| Above expend. as percent of national product | 14.0 | 16.5 | | | 8.2 | | | |

Sources: For Great Britain: Economic Survey for 1949, Finance Accounts of the United Kingdom, 1946-49, Monthly Digest of Statistics of the Central Statistical Office, and Records and Statistics, Supplement to the Economist. For the United States: U. S. Statistical Abstract, The Social Security Almanac of the Conference Board, Facts and Figures on Government Finance, 1948-49, of the Tax Foundation, and the following publications of the Department of Commerce, Bureau of Census; Compendium of State Government Finances in 1948, Compendium of City Government Finances in 1947, Summary of County Government Finances in 1946, and Governmental Revenue in 1948.

maternity benefits, prenatal care, medicines, eyeglasses, and the now celebrated false teeth; also family allowances for each child except the first one; free milk for school children; sickness and funeral costs; subsidizing of basic foodstuffs; subsidizing of rents and housing for low income groups; accident, sickness and unemployment benefits, and, of course, pensions in old age.

In contrast, the cost of governmental functions in the United States included in the first group absorbed about 14 per cent of our national income. Per capita it was some 26 per cent higher (in terms of the old pounds) than in Great Britain, largely because we spent a great deal more on foreign relief and national defense. The remaining expenditures, which represent the cost of veterans' compensation, farm subsidies and federal and local subsidies to hospitals, schools, and public welfare institutions, as well as grants to and taxes collected for social insurance and related programs, were about the same per capita as in Great Britain, but relative to the national product only about one-half as high. In Great Britain veterans' compensation represented about 7 per cent of the welfare expenditures covered in the table; in this country they accounted for over 40 per cent. Were they excluded, it would be seen that the welfare expenditures in Great Britain absorbed 14 per cent of the national product, as against less than 5 per cent here.

Unless the present trend is reversed, real relief to the British economy can come only from expansion of production, greater efficiency and productivity, and a resulting increase in national income per capita. The dilemma posed by the welfare program is that the crushing tax burden destroys incentive and stands in the way of saving and capital formation, which in the long run are the sources of welfare.

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